TEXAS DEPARTMENT OF BANKING	Bank Name/City:
	Charter #:
	Exam Date:
	Performed By:

#9 - Earnings

Assignment Overview

A well-performed analytical review of earnings provides an understanding of the bank's operations, and highlights matters of interest and potential problems which, if detected early, might avert more serious situations. Earnings should be sufficient to cover the bank's recurring expenses and provide adequate reserves, leaving a net profit to contribute toward capital accretion and pay dividends. In evaluating earnings, comparisons are made between current and historic performance, and to the performance of other banks of similar size and characteristics. Management's profit plans and budgets should be reviewed since planning and prospects are important to the long-term viability of the financial institution. Examiners may also want to review a sample of income and expense accounts and call reports to verify data and ensure proper accounting techniques. For additional guidance, refer to **FDIC Risk Management Manual of Examination Policies, Section 5.1 – Earnings** and the DOB's Reference Material document applicable to this procedure.

Instructions

IMPORTANT! These procedures are designed to promote critical thinking. Your comments should include what you looked at, what you found, and your conclusions. It is your narrative that should tell the story for a reader who may not be familiar with this bank. The reader/reviewer should have a thorough understanding of what was performed and conclusions made.

Examiners must follow the instructions below and the requirements in the Examiner Bulletin addressing Guidelines for Procedures and Work Paper Documentation for Commercial Examinations. **If there is a conflict between these Instructions and the Examiner Bulletin, the Instructions prevail**. Documentation should support weaknesses and criticisms. All examiners performing these procedures must be listed above in the "Prepared By" section.

Examiners are responsible for exercising sound judgment and utilizing reasonable investigative and analytical skills to arrive at an accurate assessment of the risk profile of this segment of the institution's operations.

Evaluation Factors, Risk Guidance, and Comments

The focus of this procedure is to evaluate and address each of the Evaluation Factors.

The Risk Guidance is provided to guide the examiner in developing a full and complete analysis for the Evaluation Factor. Examiners should consider the items under Risk Guidance and will use their discretion to determine when to comment on a risk guidance item. Examiners should consider what data or findings merit emphasis and which are secondary or of little importance.

The examiner is expected to write a comment in the Conclusions box that is complete and supportive of findings, recommendations, and ratings.

The examiner may also address areas not included in the Risk Guidance section as it is not intended to be all inclusive.

To view the Risk Guidance, click on the arrow to the left of the "Risk Guidance" text.
To Hide the Risk Guidance, click on the arrow again.

Documentation

Supporting documentation should include the standard required documents identified in the Reference Documents section for each Evaluation Factor.

- Embedded documents should be named such that the reviewer will know the contents.
- If a required document will not be included for any reason, DO NOT DELETE the document title, instead, check either :
    - "Not Included" and add a reason why OR
    - "N/A" if a document is not applicable".
- Any other relevant documents may be added to fully support the examiner's findings. These documents may be embedded in the Reference Documents section.
- **If a document needs to be reference in more than one Evaluation Factor comment, include a reference in the comment indicating the Evaluation Factor where the document can be found.**

Documentation is to be sufficient to allow an audit trail of the examiner's thought process and all significant findings.

Violations of Regulations

Violations of regulations should be addressed under the appropriate Evaluation Factor. Indicate compliance using the drop-down box next to the regulation in the Compliance section. Address non-compliance in the Comment section.

Yes = In compliance

No = Not in compliance

***Not Applicable* =** Requirements in the regulation do not apply. For example, if there were no dividends paid, then the regulation related to approval of dividends would reflect "Not Applicable".

Nonconformance with Policy

Adherence with best practices identified in Department and federal financial regulatory policy/guidance should be addressed under the Comments for the appropriate Evaluation Factor. Indicate if the bank adheres to the best practices using the drop-down box next to the appropriate policy in the Adherence to Policy section. Comments regarding best practices should be summarized in the Summary Comments.

Summary Comments and Conclusions

The Summary Comments and Conclusions should be a high-level summary that highlights the examiner's material findings and conclusions. A description of what to include in the Summary Comments and Conclusions is provided. These comments are not intended to be a report ready comment and will contain comments that may not be report worthy. Summary comments must support the Summary Rating.

The EIC will determine if the use of bullet points is appropriate for completing the Summary Comments and Conclusions. *The SEIC/EIC will have discretion in determining what is included in the Report of Examination.*

Navigating this Procedure

This procedure can be easily navigated by clicking on View from the Word menu bar then selecting Navigation Pane found in the Show section. All headings in this document will appear on the left side of the screen, for easy navigation through the document.

Performing alternate or expanded procedures not listed with these guidelines may be necessary to complete this risk analysis.

Summary of Findings

#9 Earnings – Summary Comments and Conclusions
Document conclusions regarding the adequacy of earnings considering the quality and source (including any recalculation for nonrecurring items), level and trend, the ability to provide for adequate capital through retained earnings, the adequacy of the budget process, adequacy of provisions to maintain an appropriate allowance account, and the proper management of risks. Include recommendations for implementing best practices from policies and Management's responses to weaknesses. *The SEIC/EIC will determine what to include in the report of examination.*
Summary Rating: **Select Rating**

Definitions for Summary Ratings –

CAMELS: 1-Strong; 2-Satisfactory; 3-Less than satisfactory; 4-Deficient; 5-Critically deficient

Ratings Matrix.xlsm

Violations

Prepare a comment for any violation cited. Include management's response.

Earnings Analysis

EVALUATION FACTOR 1:
Review the last examination, most recent internal/external audit, and correspondence to identify any recommendations, violations, Matters Requiring Attention, or regulatory enforcement actions. Determine Board and Management's efforts to comply with or correct noted deficiencies or concerns.

Reference Documents	Conclusions – Evaluation Factor 1
Prior Examination Criticisms and/or Audit Exceptions ☐ N/A ☐ Not Included Copy of Management Response/Corrective Action ☐ N/A ☐ Not Included	

EVALUATION FACTOR 2:
Determine the composition, quality and adequacy of earnings given the size, complexity, and risk profile of the bank.

Risk Guidance

1. **Evaluate the quality and the adequacy of earnings by analyzing peer, level, and trend of:**
   a. Return on Assets
   b. Net interest margin (NIM)

c. Asset yields
d. Cost of funds
e. Noninterest income
f. Overhead expense
g. Provision expense

2. **Consider the impact of any of the following:**
   a. Significant increasing/decreasing trends
   b. Instances where ratios are well above/below peer and reasons why.
   c. Market fluctuations and interest rates
   d. Impact on interest income or overhead due to changes in strategic plan
   e. Impact of any fiduciary income, insurance income or other source of fee income.
   f. Amount and volatility of income from high-risk assets, asset concentrations, and accounting practices subject to management discretion, which could all manipulate earnings.

3. **Consider the level and trends of provisions to the ALLL (or ACL, when applicable) and the relationship to actual loan losses to determine the impact of asset quality on earning**s.
   a. Will additional provision expense be needed as a result of examiners loan review findings?

4. **Consider the impact of any nonrecurring income or expenses and recalculate the ROA excluding these items.**

5. **Determine whether the current level of earnings is sustainable. Consider the following:**
   a. Level and trend of the ROA, NIM, overhead, fee income, and ALLL (or ACL, when applicable) provisions;
   b. Asset quality trends;
   c. Management's ability to forecast or control funding and operating expenses;
   d. Strategic Plans, including new initiatives;
   e. Competitive and economic conditions; and

f. Vulnerability to adverse events.

6. **Investigate any unusual income or expenses accounts as necessary.**

Refer to APPENDIX A for additional guidance.

Reference Documents	**Conclusions – Evaluation Factor 2**
Exam Date and Most Recent Year-end Income Statement ☐ N/A ☐ Not Included Supporting Documents	

EVALUATION FACTOR 3:
Determine the adequacy of the bank's planning and budgeting processes and the board and management's oversight .

Risk Guidance

1. **Review the budget, considering:**
   a. Preparation practices
      i. Are the following areas considered:
         a) Strategic plans,
         b) New or changing products and business lines,
         c) Growth objectives,

d) Are revenue sources reasonable and consistent with the asset mix,

e) Are expenses consistent with prior periods adjusted for growth,

f) Are provision expenses directionally consistent with loan growth,

g) Are taxes appropriate for the level of income,

h) If there are changes to product or services, is the related income and expenses reasonably forecasted,

i) If material interest rate risk exists, do budget assumptions address the mismatch and strategy to reduce IRR?

b. Large variances between budget and actual performance

   i. Does the format provide a process for identifying changes from the prior year?

   ii. Does the format provide for identifying variances during the plan year?

c. Material adjustments or revisions to original budget

   i. Has a materiality level been established for different budget categories?

   ii. Are material variances reported to the board or appropriate committee, with appropriate written analytical comments?

d. Deficiencies in the process

   i. If there are material variances between budget and actual, has the board or appropriate committee determined the reason for the discrepancy so the mistake or error isn't repeated in the future?

2. Evaluate management and Board involvement in the budgeting and planning processes, considering:

a. Are the right personnel involved in the process?

b. Does the timeline for preparation and approval of budget provide sufficient time to create a quality product?

c. Does the Board approve the current year budget, and do the minutes contain sufficient discussion?

d. Do Board contain sufficient information regarding bank earnings performance and variances during monthly meetings?

e. Does the board have a threshold when revisions to the bank budget are warranted, and a process for approval?

   i. Is the basis for budget revisions reasonable and appropriate?

3. **If there are nonrecurring expenses or income that are material, recalculate the projected year-end ROA adjusting for the extraordinary items.**

Reference Documents	Conclusions – Evaluation Factor 3
Comparison of Actual to Budget (Most Recent and Prior Year-end) ☐ N/A ☐ Not Included Supporting Documents:	

EVALUATION FACTOR 4:
Evaluate accounting and internal controls concerning income and expenses.

Risk Guidance

Consider the following:

1. **Accounting Controls**
   a. Have there been any significant accounting errors or adjusting errors to income and expense accounts noted by auditors or amendments to call reports?
   b. Are there any ledger accounts entries that are unusual items or are there any significant fluctuations?
   c. Are significant accounts reconciled and reviewed on a regular basis?
2. **Internal controls**
   a. Is the accounting department part of the annual risk assessment?
   b. What was the date of the last internal review, and were there exceptions noted?

c. Is there sufficient segregation of duties?

d. For large items what is the threshold for dual authorization?

e. Are general ledger accounts reviewed and reconciliations approved by personnel other than the preparer?

f. Are significant or nonrecurring income, expenses, and capital charges reviewed and authorized by senior management and the Board?

3. **If the bank's total assets exceed $500 million, obtain, review and determine adequacy of the internal control reports required by FDICIA.**

OPTIONAL: *For training purposes or if there are weaknesses noted, consider reconciling and verifying Call Report schedules. Coordinate with other examiners to verify proper categorization of GL accounts against Call Report schedules RI, RI-E, RC-K for the most recent year-end. If numerous or amendable errors are noted or there have been errors in the past, then verify current period. See APPENDIX B.*

If weaknesses are noted, notify the examiner working audit and the EIC.

Reference Documents	Conclusions – Evaluation Factor 4
Supporting Documents:	

EVALUATION FACTOR 5:
Determine whether the bank is in compliance/conformance with each applicable regulatory requirement or interagency policy listed below or any other applicable law or regulatory guidance.

Risk Guidance

Determine if the bank's system of earnings review meets the requirements of the Interagency Guidelines Establishing Standards for Safety and Soundness (12 CFR 364 for Nonmembers and 12 CFR 208 Regulation H, Appendix D-1 for member banks)

An insured depository institution should establish and maintain a system that is commensurate with the institution's size and the nature and scope of its operations to evaluate and monitor earnings and ensure that earnings are sufficient to maintain adequate capital and reserves. The institution should:

a. Compare recent earnings trends relative to equity, assets, or other commonly used benchmarks to the institutions historical results and those of its peers;

b. Evaluate the adequacy of earnings given the size, complexity, and risk profile of the institution's assets and operations;

c. Assess the source, volatility and sustainability of earnings, including the effect of nonrecurring and extraordinary income and expense;

d. Take steps to ensure that earnings are sufficient to maintain adequate capital and reserves after considering the institution's asset quality and growth rate; and,

e. Provide periodic earnings reports with adequate information for management and the Board of Directors to assess earnings performance.

Compliance with Regulations	
Interagency Guidelines Establishing Standards for Safety and Soundness (12 CFR 364, Appendix A or 12 CFR 208, Appendix D-1, as applicable to Nonmember/Member banks)	**Select Response**

Reference Documents	**Conclusions – Evaluation Factor 5**
Supporting Documents:	

APPENDIX A

Evaluating Earnings

Guidance on Evaluating the Significance of Nonrecurring Items:

1. Identify all extraordinary (nonrecurring / nonoperating) income and expense items and amounts for the current period and each prior year-end since the last examination. The following are examples of extraordinary items, but it is **not** all-inclusive:
   - These are always considered non-operating:
     - Securities gains/losses,
     - gains/losses on the sale of OREO and other assets,
     - law-suit settlements,
     - and insurance settlements
   - It is also possible for some ALLL provisions to be considered extraordinary (consult with the examiner performing the ALLL review).
   - Large attorney's fees may be considered nonrecurring if a lawsuit or other legal issue caused a temporary need for legal assistance.

2. Determine to what extent extraordinary items have impacted net income by eliminating these items from the calculation for ROA. **Do not ignore the tax effects.**
   - Current period ROA adjusted for nonrecurring items:
   - Prior year-end(s) ROA adjusted for nonrecurring items:

In the Evaluation Factor conclusions, comment on the extent that the bank is operationally profitable, i.e., able to meet its needs outside of extraordinary or nonrecurring items, noting the extent to which these items contribute to or detract from net income.

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APPENDIX B

CALL REPORT ERRORS

1. Determine if the errors are considered significant. The FDIC's Call Report Analysis Unit (800-688-3342 or 202-898-6607) may be useful in determining the necessity of amendments.

   Information is material if omitting it or misstating it could influence decisions that users make on the basis of the financial information of a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude or both of the items to which the information relates in the context of an individual entity's financial report.

   A general guideline for materiality is 1% or more of total assets or 1% or more of total revenues.

   Exceptions are allowed for amounts in excess of these general levels if both the EIC and RD agree that the error does not materially change the financial condition or risk profile of the institution. EIC and RD support should be adequately documented and explained.

2. Compile a list indicating: A) Significant, Amendable Errors and B) Irregularities (immaterial errors). Provide a copy of this list to the AEIC. Include copy of list in work papers.

3. For all significant amendments, request the bank to file amended reports within 20 days from the date of request and include a comment in the open section of the report.

   - If 5 or more errors are found that do not require an amendment to the Call Report, a general comment on the errors should be made in the open section.

4. If it is determined those Call Report errors are deliberate or the result of gross negligence, consult with your Regional Director to determine if a Suspicious Activity Report (SAR) should be filed.

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